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Competition *policy brief*

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State aid for airline restructuring: Does it give you wings?

1. State aid control 2.0

The Commission is modernising all the rules it uses for its State aid control. The Commission's guidelines are being revised to align them with the priorities of the EU's growth strategy, Europe 2020. The new rules will encourage Member States to put in place well-designed aid measures which further economic growth and objectives of common EU interest, while preserving competition in the single market. At the same time, the Commission will focus on the cases with the strongest impact on the single market, and will simplify the rules so as to make them easier for Member States to implement. In that context, the Commission has revised its rules on State aid to rescue and restructure firms in difficulty. These rules apply in all sectors of the economy except the financial sector, where specific rules are in place due to the crisis. In the aviation sector, many carriers have undergone difficulties in the last few years and have received public support. The Commission has already taken a number of decisions on restructuring aid and is still assessing more cases.

2. Brief explanation of rescue and restructuring rules

Why impose strict conditions on rescue and restructuring aid?

Financial distress plays an important signalling role in the economy, indicating that a firm isn't making optimal use of its resources. The so-called churn process, that is to say the exit of firms and their replacement by others, is an important driver of productivity growth. To boost productivity in the EU – and in particular help close the gap with the US – so that sustainable jobs can be created, the churn process in Europe needs to be encouraged. Interventions that interfere with it, such as rescue and restructuring aid, should be subject to strict control.

Furthermore, when troubled firms receive aid, their more efficient and more innovative peers see the rewards for their efforts disappear. This results in loss of incentive to invest and grow, and thus loss of opportunities to raise productivity and create jobs across the single market. Aid granted to firms in distress can delay adjustments and ultimately waste public money. That's why this type of aid is particularly distortive and requires close scrutiny and strict conditionality.

The rescue and restructuring guidelines in practice

The Commission has just adopted new rescue and restructuring aid guidelines to replace those in place since 2004. The new rules draw on the key principles of the 2004 guidelines, which are maintained, and introduce a number of improvements¹.

The 2004 guidelines, which set out the conditions under which companies in difficulty can receive State aid, were the basis for nearly 200 individual rescue and restructuring cases over the past ten years (all sectors included), including the restructuring of Austrian Air, Air Malta, Czech Airlines, airBaltic and Adria Airways.

In a nutshell

The rescue and restructuring guidelines allow for granting of State aid under strict conditions, ensuring that the aided company will become viable without continued state support. This helps to transform and modernise the European aviation sector, which needs strong and healthy airlines to meet citizens' transport needs. Experience shows that even if an airline goes bankrupt and can't be restructured to become viable again, its disappearance doesn't mean the Member State concerned will lose its connectivity.

¹ See *Competition Policy Brief no 9 of 2014*

For restructuring aid to be approved, three main principles must be complied with: first, there must be a credible restructuring plan capable of restoring the long-term viability of the company without further public support. Second, the company must make an own contribution, at the appropriate level, to the costs of restructuring, to avoid the entire burden falling on taxpayers. Third, measures should be introduced to mitigate the distortions of competition created by the aid. Finally, a given company can't receive rescue and restructuring aid more than once every 10 years (the "one time last time" principle). The Commission will still focus its assessment on these elements under the 2014 Guidelines, as it did under the 2004 Guidelines.

3. Restructuring in the aviation industry

European aviation industry

Aviation plays a fundamental role in the European economy for both EU citizens and industry, with more than 15 million annual commercial flights, 150 scheduled airlines, a network of over 440 airports, and 60 air navigation service providers. Airlines carry about 40 per cent of value of Europe's exports and imports, and transport 822 million passengers per year to and from Europe.

Over the past 20 years, the EU airport industry has undergone fundamental changes. Previously airports were mostly managed as public infrastructure to ensure accessibility and territorial development. In recent years, they have specific commercial objectives and are competing with each other to attract air traffic. Over the last decade, many former military or general aviation airports have been converted into civil aviation airports. This development has been supported by the emergence of low-cost carriers (LCCs).

Low-cost carriers have brought important benefits to passengers, enabling millions of European citizens to travel more cheaply. In 1992, over 65 per cent of passenger seats were sold by incumbent air carriers and only 1.5 per cent by LCCs. In 2011, LCCs achieved a market share of 42.4% of passenger seats and thus exceeded the market share of incumbent air carriers (42.2%) for the first time. This trend continued in 2012.

The emergence of LCCs, combined with the effects of the financial and subsequent economic crisis, has considerably changed the landscape of the industry. Some airlines, especially traditional flag-carriers, have experienced difficulties. Even before the crisis, the Commission dealt with several such cases of airlines receiving public support (Alitalia in 2005, Cyprus Airways in 2007, Olympic Airways in 2008 and Austrian Airlines in 2009).

Since then, the need has been increasing for State aid to restructure small and medium-sized traditional air carriers. Since 2010 the Commission has received notifications of restructuring aid to Czech Airlines, Air Malta, LOT Polish Airlines, airBaltic, Adria Airways, Cyprus Airways and Estonian Air.

Main elements of aviation restructuring plans

The key criteria for assessing airline restructuring cases are the same as for restructuring of companies in other sectors. However, the aviation sector has its particularities (traditional versus low-cost business model; network industry; connectivity issues), and given the number of airline restructuring cases the Commission deals with, a more sector-specific assessment framework has been developed over the past couple of years.

The main criterion for obtaining approval for State aid is the existence of a viable restructuring plan. The main elements of the return to viability in the airline industry consist of streamlining operations in order to focus on the core business of passenger transportation. Airlines also try to improve their cost base by focusing on a more unified fleet of aircraft, reducing catering costs in economy class, minimising personnel costs and so on. As regards revenue initiatives, many traditional carriers under restructuring took inspiration from low-cost carriers and introduced base fare products to which extra services can be added for a fee (extra leg room, priority treatment of passengers, etc.).

Last but not least, the carriers whose restructuring plans were assessed positively by the Commission all included a redefined network, focusing on the most profitable connections and synergies to be exploited on the basis of their geographical locations.

Own contribution

In accordance with the guidelines, the air carriers must contribute to the cost of restructuring. The guidelines require that large companies finance at least 50% of the restructuring costs with a real contribution, meaning money that the company managed to receive and excluding any theoretical potential future profits. The Commission can accept a lower level of own contribution only in specific circumstances, such as in cases where the beneficiary is located in an assisted area. In its past practice, the Commission accepted a lower contribution in justified cases; in the case of Air Malta, it was concluded that a contribution of 45% was justified since Malta is an assisted area and has a specific peripheral geographical situation, which causes problems with access to the rest of the EU.

Limiting competition distortions

Another important requirement of the rescue and restructuring guidelines is reducing (non-loss-making) activities in order to limit the distortive impact of the State aid on competition. Indeed, the aid is detrimental to the beneficiary's competitors who receive no such State aid. Measures which would be required anyway for the company's return to viability, i.e. measures which the company would need to take to optimise its operations, cannot be taken into account in this respect. For airlines' return to viability, reducing fleet and restructuring the flight network are among the first measures envisaged.

So they need to come up with measures that go beyond those necessary for the timely return to viability, in order specifically to address the distortions of competition created by the aid.

In past cases, additional reduction of capacity was accepted. The airline industry uses the Available Seat Kilometres (ASKs) to capture the total passenger capacity of an airline. This is calculated as the total number of scheduled seats available for passengers, multiplied by the total number of kilometres those seats were flown. The reduction of capacity is therefore often calculated in terms of ASKs.

When airlines reduce their capacity, they also give up slots allocated to them for landing and take-off, associated with the flights given up. Those slots can then be used by any other airline for any other route from/to that airport. Some airports already have spare slot capacity, so slots given up by an airline under restructuring don't necessarily present an additional opportunity for competitors. However, at congested airports, slots are scarce. Those airports are called "coordinated airports": when slots are made available due to a discontinued flight, they are placed in a pool and allocated to interested airlines. This means that slots in coordinated airports could be considered as separate and additional measures, because they are not linked to the route in question.

One time, last time principle

The rescue and restructuring guidelines also contain a very strong principle: no more aid for a company that has received rescue or restructuring aid in the past ten years. This principle ensures that public money isn't wasted on repetitive interventions to the benefit of companies that perhaps cannot compete and be viable in their markets.

Monitoring implementation

The Commission follows the restructuring process closely through monitoring reports sent by the Member States that granted the State aid.

4. Past and current airline restructuring cases

Past restructuring cases

Under the 2004 guidelines, the Commission authorised the granting of restructuring aid in the cases of Austrian Airlines, Cyprus Airways, Air Malta and Czech Airlines, on the basis of restructuring plans which comply with the requirements of the guidelines. The most recent positive decisions concern airBaltic and Adria Airways, which were adopted on 9 July 2014, together with a decision finding that the Scandinavian airline SAS did not receive any State aid. In the case of airBaltic the Commission authorised restructuring aid of about EUR 100 million, and for Adria Airways about EUR 80 million.

In the case of Malév, the Hungarian flag carrier, the Commission concluded that the State aid granted was incompatible with EU rules and ordered the recovery of past incompatible aid. The

company had benefited from State aid measures between 2007 and 2010 without any duly notified restructuring plan. Malév could not demonstrate how it would become viable again and its business plan contained no evidence that a private source would be contributing to the costs of restructuring. The plan also contained no compensatory measures to minimise the competition distortions brought about by the significant State support. Finally, Malév had already repeatedly received State support over the last few years. Malév subsequently filed for bankruptcy.

On-going investigations

The Commission currently has three open formal investigations into measures granted to other traditional flag carriers.

Member State	Company	Possible aid amount	State of play
Cyprus	Cyprus Airways	Ca. EUR 100m (capital injections, debt-to-equity swap)	Formal investigation procedure opened in March 2013 (rescue aid) and February 2014 (restructuring aid), assessment on-going
Estonia	Estonian Air	Ca. EUR 80m (loans and capital injection)	Formal investigation procedure opened in February 2013 (rescue aid) and February 2014 (restructuring aid), assessment on-going
Poland	LOT Polish Airlines	EUR 200m (capital increase)	Formal investigation procedure opened in February 2014, assessment on-going

5. Connectivity issues: what happens if a negative decision is adopted

The Commission assesses each and every case on its own merits. Often, it is argued that the country would suffer significant loss in GDP due to a potential loss of connectivity if the traditional flag carrier went bankrupt. The Commission analyses these arguments carefully and assesses the situation on the market for each company concerned (especially with regard to size of the market, geographical position, number of routes already operated by competitors, etc.). However, companies which cannot be made viable again shouldn't be artificially supported by taxpayers, harming competition in the single market. If a non-viable airline exits the market, it doesn't necessarily mean that the transport needs of citizens won't be met and that the Member State concerned will suffer economically.

Recent examples of failed airlines

Malév, which stopped operations in February 2012, accounted for 37% of passengers from Budapest. However, within five days of its grounding, other airlines had taken over 60% of Malév's point-to-point traffic. At the end of 2012, low-cost carriers accounted for 51% of traffic at Budapest, up from 26% before the demise of Malév. By the end of 2012, the year-on-year fall in passenger numbers at Budapest had been cut to just 4.7%. Direct destinations decreased from 84 cities reachable in 2011 to 74 in 2012. It is estimated that capacity measured in Available Seat Kilometres (ASK) is 10% lower than before Malév's collapse.

FlyLal was the national airline of Lithuania and its main base was Vilnius. After the government declined twice to bail out the airline, FlyLal ceased operating in January 2009.

The disappearance of FlyLal reduced the number of direct flights from Vilnius from 28 to 14 destinations, while the number of passengers decreased by approximately 36% in 2009. However, since then the number of passengers has increased steadily, and in 2012 exceeded the pre-crisis figures for 2008. In terms of destinations from Vilnius, currently there are 34 direct destinations operated by more than 20 airlines. The presence of low-cost carriers in Vilnius, in particular Wiz Air and Ryanair, is very significant.

Slovak Airlines was the flag carrier of Slovakia, with its main base in Bratislava. It ceased operations and filed for bankruptcy in early 2007. Several other airlines based in Bratislava (Air Slovakia, Sky Europe) have also stopped operations in the past years for a number of reasons. Bratislava has not experienced significant connectivity difficulties since Vienna Airport is very close (approximately 50 Km).

Spanair ceased operations in January 2012 at Barcelona Airport. Most of its capacity was quickly replaced by Vueling. Iberia and Ryanair also increased their operations from Barcelona. Capacity at Barcelona Airport is currently estimated as equal to, if not higher than, the levels before Spanair's collapse.

The examples of failed airlines show that in the short term some direct routes will necessarily be lost. However, as the examples illustrate, the number of direct destinations from the affected airports can increase significantly in the short- to medium-term and may exceed those available before the collapse of the national carrier. That increase appears to be mainly due to low-cost carriers.

Possible ways of ensuring connectivity

What are the options Member States have, if the Commission concludes that a certain flag carrier benefitted from unlawful and incompatible State aid which the airline is not able to repay due to its financial situation?

- Bankruptcy and liquidation: If the Commission adopts a decision finding that aid was incompatible and must be recovered from the carrier, the possibility of liquidation for the national carrier under assessment appears likely. Although at first glance this scenario may not appear ideal for connectivity, the experience of Malév shows that connectivity may not necessarily be endangered, as other airlines may take over the traffic.

- Setting up a new airline: Private investors can set up a new airline using some of the assets of the previous flag carrier, such as planes. However, if the Commission adopts an incompatible aid decision with recovery, the sole option for the Member State to exclude recovery of the incompatible aid from the new airline would be to demonstrate that there is no economic continuity between the two companies. The Commission assessed and accepted this argument in the case of Alitalia in 2008.

- Ensuring connectivity on the basis of Public Service Obligations (PSO): PSO contracts meeting the requirements of the EU's air services Regulation (Regulation 1008/2008) would ensure that the routes considered vital for economic and social development are served. Although it's possible to have PSO on intra-EU routes, a limited number of Member States makes use of PSO. This possibility is not used by countries in central and Eastern Europe, in particular.

PSO in operation (2013)²



² Source: R. Merkert, B. O'Fee/Transport Policy 29 (2013). In a presentation by DG MOVE – Air transport perspectives in Central, Eastern and South-Eastern Europe.

6. Outlook

Europe's recovering economy needs a well-performing aviation industry, which operates efficiently and provides for sustainable jobs and adequate connectivity at reasonable prices for European citizens.

The provisions of the rescue and restructuring guidelines allow for granting of aid under strict conditions, ensuring that the aided company will become viable without continued state support, that the company contributes to the costs of the restructuring, and that distortion of competition created by the aid is effectively offset. These guidelines thus lead to effective restructuring efforts being undertaken by troubled flag carriers, and so help transform the European aviation market into an industry with strong and healthy airlines.